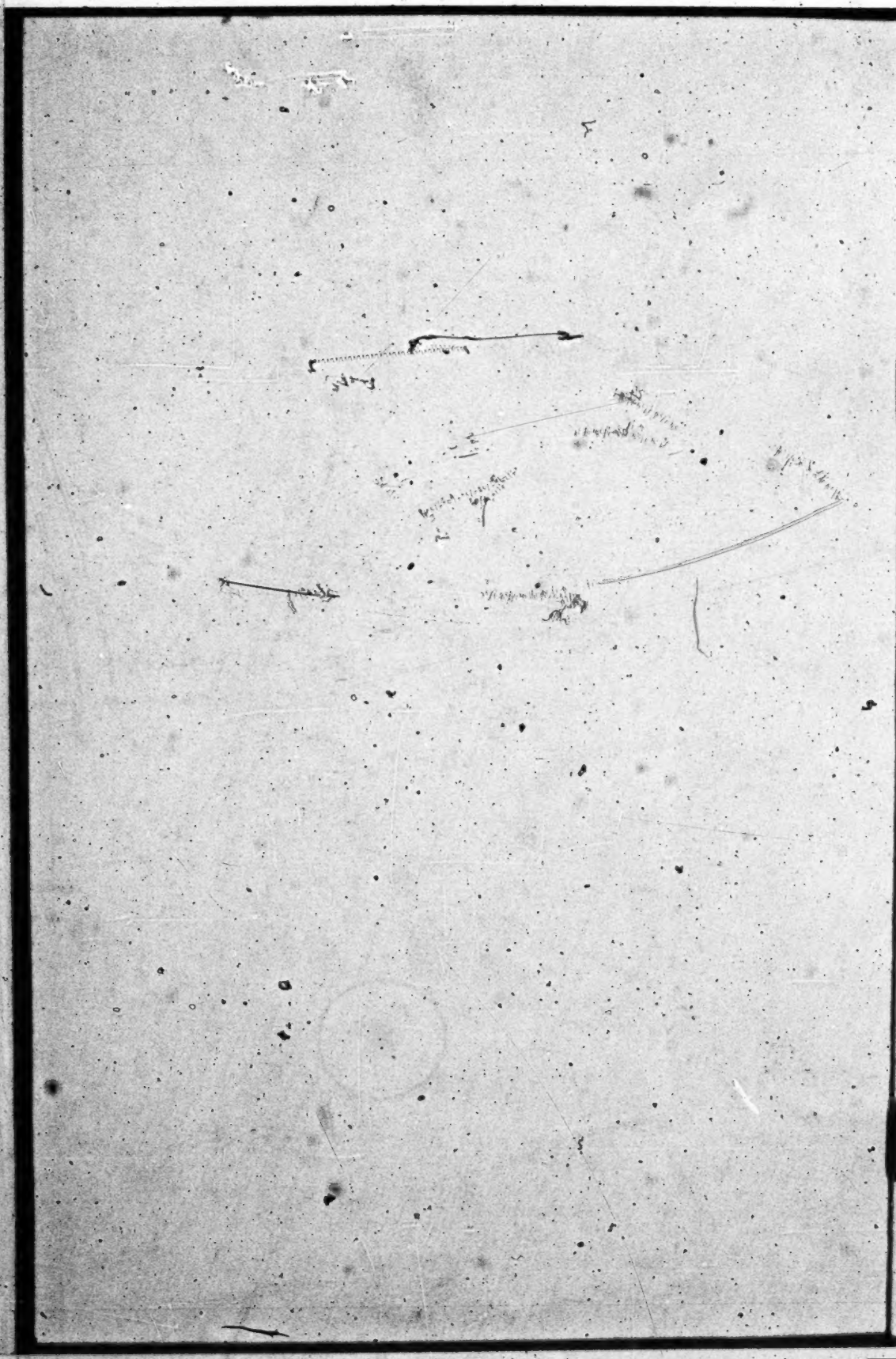

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of Webb & Knapp, Inc., etc.,

Petitioner,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In challenging the Trustee's standing to prosecute an action on behalf of debenture holders against Marine, Marine asks this Court to reject positions never taken by the Trustee and arguments never made by him. Contenting itself to setting up, and then knocking down, these strawman contentions, Marine only rarely even attempts to meet those arguments which *were* made by the Trustee. Furthermore, in the final analysis Marine would have this Court

impose a standing requirement even more restrictive than that adopted by the Court below.

POINT I.

A Chapter X Trustee is the appropriate party to commence an action on behalf of debenture holders against an Indenture Trustee when, as here, the subject matter of the action is significantly related to the debtor's affairs.

1. Far from formulating an "*ad hoc* rule of no rule at all" (Resp. Br. 23), the standing rule sought by the Trustee takes into account the practical realities of the corporate reorganization process. Marine attempts to portray the Chapter X trustee as a ministerial officer who goes about collecting the various properties of the estate and distributing them in accord with a fixed schedule of priorities, as though using a check list. This view of the trustee, possibly accurate to a point in the context of *straight bankruptcy*, is totally at odds with the concept of the trustee as the 'focal point' for reorganization envisioned by the framers of Chapter X.*

The reorganization trustee is not merely, or even primarily, a supervisor of the liquidation of corporate assets. On the contrary, he is charged with the complicated task of taking a financially-crippled corporation and, through the deft use of business management, corporate finance and legal processes, rehabilitating the corporation and salvaging a financial interest for various classes of its creditors as well as its stockholders and other investors. See, e.g., *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594, 603-604 (1965).

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* H. Rep. 1409, 75th Cong., 1st Sess. (1937), 43-44. (Pet. Br. 10-11).

It is this reorganization process* which is at the very heart of Chapter X, and not, as Marine would have this Court believe, an apparently semi-automated search for property, on a statutory subsection-by-subsection check list basis (Resp. Br. 13-15).

The "practical dynamics of bankruptcy reorganization," which Marine belittles (Resp. Br. 25), are vividly portrayed in the two recent proceedings in the Eastern District of New York, ignored entirely by Marine, in which reorganization trustees negotiated settlements with indenture trustees in circumstances comparable to those involved here.**

2. In line with these practical dynamics of reorganization, the formulation of the standing rule which the Trustee suggests is that the subject matter of the action have a *significant relationship* to the debtor's affairs. In determining whether such a significant relationship exists, several factors would come into play. These would include whether the subject matter of the action was one which the trustee was required in the normal course of his duties to investigate and report upon under Section 167(3) of the Bankruptcy Act; whether the alleged activities of the defendant contributed to the debtor's underlying financial problems; the possible impact of the action upon the formulation or acceptance of a plan of reorganization; the amount of the claim; and the number of investors and creditors of the debtor who would benefit directly from any recovery obtained. Under these or similar criteria (always subject to the protection that the Bankruptcy Court, as advised by the SEC, must approve the initiation of the action) a

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* As Judge Kaufman below stated, "not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed formulas", but by "a process of negotiation, and some give-and-take, in an attempt to adjust equitably . . . the rights of competing interested parties." (99a-100a).

** *In re Continental Vending Corp.*, E.D.N.Y. 63-B-663, and *In re Dilbert's Leasing & Development Corp.*, E.D.N.Y. 63-B-148 (See Pet. Br. 30-31).

Chapter X Trustee does (and should) have standing to prosecute claims against a wrongdoing indenture trustee on behalf of debenture holders.

Such a standing rule would be neither inconsistent with the statutory language nor at odds with the statutory scheme. The error in Marine's attempt to restrict the effect of Section 187 of the Bankruptcy Act, 11 U.S.C. Sec. 587, by reading this Court's decision in *McCandless* v. *Furlaud*, 296 U. S. 140 (1935) as limited to the issue of estoppel (Resp. Br. 35) is underscored by the very passage from Mr. Justice Cardozo's decision in that case upon which Marine relies. The "wrong" here, as in *McCandless*, is the "unlawful depletion of the [debtor's] assets" in violation of the indenture, an unlawful depletion made possible only through the complicity or gross negligence of Marine.*

3. Indeed, Marine, in urging that the inquiry be limited to the status of the Trustee's claim as property of the estate, retreats even from the alternate inquiry suggested in *Clarke* and by the majority below as to whether the claim would affect the plan of reorganization. This strategic retreat is understandable in light of the erroneous conclusion by the court below on the question of subrogation, namely, that if the Trustee prevailed "Marine would simply be substituted for the debentureholders as the claimant" (92a). Marine does not even attempt to defend this blanket conclusion or the mistaken reliance by the Court below on the Restatement of Security (see Pet. Br. 26-28),

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* Moreover, Marine ignores Section 212 of the Bankruptcy Act, 11 U.S.C. Sec. 612, which sets forth express authority to compel an accounting by an indenture trustee, from which the Third Circuit concluded in *In re Solar Mfg. Corp.*, 200 F. 2d 327 (3d Cir. 1952), that the Chapter X trustee could counterclaim to such an account. Even granting Marine's tenuous interpretation (with which we do not agree) of Judge Learned Hand's opinion in *Prudence-Bonds*, the Third Circuit's decision in *Solar* totally belies Marine's claim to the support of *all* the courts which have previously dealt with the problem (Resp. Br. 12).

but now argues only that the Trustee really meant to allege only simple negligence rather than "gross negligence or wilful misconduct" and that therefore Marine's wrongdoing "*almost* certainly could not involve the type of culpability which sometimes leads to a denial of subrogation rights" (Resp. Br. 26-27, emphasis added). It is submitted, however, that the Trustee, not Marine, knows best what he intended to, and did, allege.

4. Marine also suggests that the Chapter X process might itself be undermined if the Trustee here is found to have standing, because a Chapter X trustee might delay consummation of a plan of reorganization while pursuing a claim against the indenture trustee (Resp. Br. 46).* The fact is, however, that trustees, whenever they are involved in litigation (even suits involving "property" of the estate as defined by Marine), must make a judgment as to whether to delay submission of a plan pending resolution of litigation or to submit a plan which makes reference to pending litigation and provision for a subsequent distribution of any recoveries obtained. The trustee's judgment in such instances—as it would be in the case of his action on behalf of debenture holders against the indenture trustee—is subject to the scrutiny of both the reorganization court and the SEC.

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* On the other hand, Marine argues that, because the Trustee here *has* submitted a plan to the reorganization court for consideration, the issue of his standing is now moot (Resp. Br. 27). That a plan has been submitted does not detract in the slightest from the *significant relationship* between the debtor's affairs and the subject matter of the action. Even assuming every argument made by Marine with respect to the issue of subrogation, the fact remains that at the very minimum, if the Trustee succeeds on the merits, a large class of debt investors will have been made whole (Pet. Br. 26-27).

POINT II.

The Trustee neither attempts to subvert the intent of Rule 23 nor to preempt other actions, but rather seeks only to provide the best representation for debenture holders under all the circumstances.

1. Marine charges that the Trustee is a "self-appointed volunteer" who would "undermine the mechanism of [Federal] Rule 23" (Resp. Br. 39). In this respect, the charge is made that the Trustee omitted Rule 23 "from his catalogue of measures enacted by Congress for the protection of investors" (Resp. Br. 20), apparently in order to further his devious scheme of thwarting the path of debenture holders whose rights Marine has stepped forth so recently to champion. The fact, as opposed to this "phantom" created by Marine, is that the Trustee has argued in favor of a procedure with not only the safeguards and benefits of Rule 23 (Pet. Br. 21), but with the additional protection that all steps, including the initial commencement of the action and any settlement thereof, would take place only with the approval of the reorganization court and under the watchful eye of the SEC.*

Marine argues that in view of Rule 23, debenture holders do not need (and should not have) a representative from outside their ranks to prosecute claims on their behalf relating to the indenture. Precisely this argument was rejected by Congress in enacting the Trust Indenture Act of 1939, one year after the codification of Rule 23. Trust Indenture Act § 302(a)(1), 15 U.S.C. § 77bbb(a)(1). (Pet.

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* This Court's recent decision in *State of Hawaii* v. *Standard Oil Co. of California*, No. 70-49, (March 1, 1972), 40 U.S.L.W. 4246, offers Marine no more than another "phantom" to flail away at (Resp. Br. 44). The Trustee here makes no claim to be acting in a *parens patriae* capacity, and the issue in the *State of Hawaii* antitrust action concerned the limits of damages under Sec. 4 of the Clayton Act and not the question of standing at all.

Br. 19.) The same considerations which militate in favor of having a representative (the indenture trustee) to protect debenture holders' rights under the indenture militate in favor of having a representative (the Chapter X trustee) to protect debenture holders' rights vis-a-vis the indenture trustee.

2. Marine points to the pendency of two debenture holders' actions in state and federal court and frames the issue before this Court as a *choice* between allowing the Trustee's action to proceed on the merits or allowing the other actions to proceed (Resp. Br. 7-9, 39-44). No such *choice*, however, is before this Court.

No attempt is made here by the Trustee to "preempt" or diminish the rights of investors, but only to augment the means of enforcing them. Permitting reorganization trustees to sue indenture trustees does not preclude investors from doing so as well, either individually or collectively. The real question is whether the rights of investors are to be made meaningful by permitting reorganization trustees to assert them. In this context, it is highly significant that Marine has nowhere denied that reorganization trustees are in a far better position than debt investors to discover, prosecute and prove claims based on the indenture trustee's failure to enforce covenants in the trust indenture (See Pet. Br. 17-19).

There is no question that individual debenture holders may prosecute their own claims against Marine. If the rule of *Elkind* v. *Chase National Bank*, 259 A. D. 661, 20 N.Y.S.2d 213, *aff'd* 284 N.Y. 726, 31 N.E.2d 198 (1940) is rejected by the New York courts (despite Marine's opposition) the most serious *legal* impediment to the maintenance of such class actions will also have been set aside.

The Trustee *never* has argued that class actions by debenture holders should not or cannot proceed in the face of an action by the Trustee. What the Trustee *has* argued,

and what Marine has totally side-stepped, is that a Chapter X trustee is in the best position to prosecute such an action (Pet. Br. 17-22) and that the commencement of such an action by the Chapter X trustee is likely to persuade bondholders that their rights are protected and therefore influence them *not* to commence additional suits. In this respect, the facts relating to the instant accumulation of lawsuits are most illustrative. Here the debenture holders' suits (Pet. Br. 21, n. 9) were commenced

> *after* the Trustee had conducted his investigation and made his report to the reorganization court pursuant to Section 167(3) of the Bankruptcy Act,*
>
> *after* the Trustee had obtained authorization from the reorganization court to commence the action against Marine, and,
>
> most importantly, *after* Marine had interposed objections as to the Trustee's standing.

In this situation, given the uncertain state of the Trustee's standing, at least in the Second Circuit, had the debenture holders, refrained from commencing separate actions against Marine, based on the information made available in the Trustee's petition for authorization to commence the action, they would have run the risk of having their rights vis-a-vis Marine totally wiped out by the statute of limitations. It is this very pressure to sue, and its result in a proliferation of class actions in state and federal courts, that is accentuated by the holding of the court below.**

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* Were it not for the Trustee's Section 167 investgation, Marine's wrongdoing might have gone totally unexposed.

** Marine's suggestion that the Trustee is somehow to blame for the delays in the separate debenture holder actions is pure myth. (Resp. Br. 39.) The *Ray* case has been delayed in state court because Marine has filed an appeal urging the state court to follow the *Elkind* rule. The *Lewis* case has been stayed on the application of Marine which was based on the pendency of this action. Marine's belated con-

3. Marine also makes vague allusions to the possibility of double recovery if the Trustee is permitted to proceed with his action, while debenture holders proceed simultaneously with causes of action based on alleged securities law violations (Resp. Br. 45, n. 18). Such a possibility is no more real than in the situation where investors simultaneously pursue common law fraud actions in state court and 10b-5 actions in federal court. Marine need only "speak up" in the second forum to assure that it is properly credited with any recovery previously obtained against it. What Marine is seeking is not to prevent double recovery but to prevent its being called upon to account at all, even once, for its wrongful acts.

4. Marine's further charge that a Chapter X trustee might "face conflicts between positions taken in litigation on behalf of the estate and related claims belonging to others" (Resp. Br. 46) is likewise made of whole cloth. In the instant action no such conflict exists (nor has it ever been alleged by Marine). Furthermore, whenever any such conflict is alleged to exist, such allegations can be brought to the attention of the reorganization court by any interested party when permission is sought by the trustee to institute suit. Finally, as added protection, the fact remains that key litigation decisions, from the initial commencement of the action to its conclusion, including any proposed settlement, are always subject to the approval and review of the reorganization court itself.

In summary, the Trustee seeks only the opportunity to proceed on the merits to recover losses on behalf of debt investors sustained as a result of Marine's wilful miscon-

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cern for the rights of debentureholders which it is asserted that the Trustee is attempting to "preempt" is belied not only by Marine's constant and vigorous opposition to these separate actions on the grounds that they cannot properly be brought as *class* actions (Pet. Br. 21, n. 9), but, in addition, by the fact that not a single debenture holder has opposed the Trustee's efforts to prosecute the instant action. Moreover, Marine seems to be saying that the later brought *Ray* and *Lewis* actions in fact "preempt" the Trustee's suit.

duct or gross negligence in failing to enforce provisions of the indenture. In so doing, the Trustee acts in accord with the statutory language and in furtherance of the policies of the Chandler and Trust Indenture Acts and with the full support of the debt investors whom he represents.

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals should be reversed and the cause remanded to the District Court.

Respectfully submitted,

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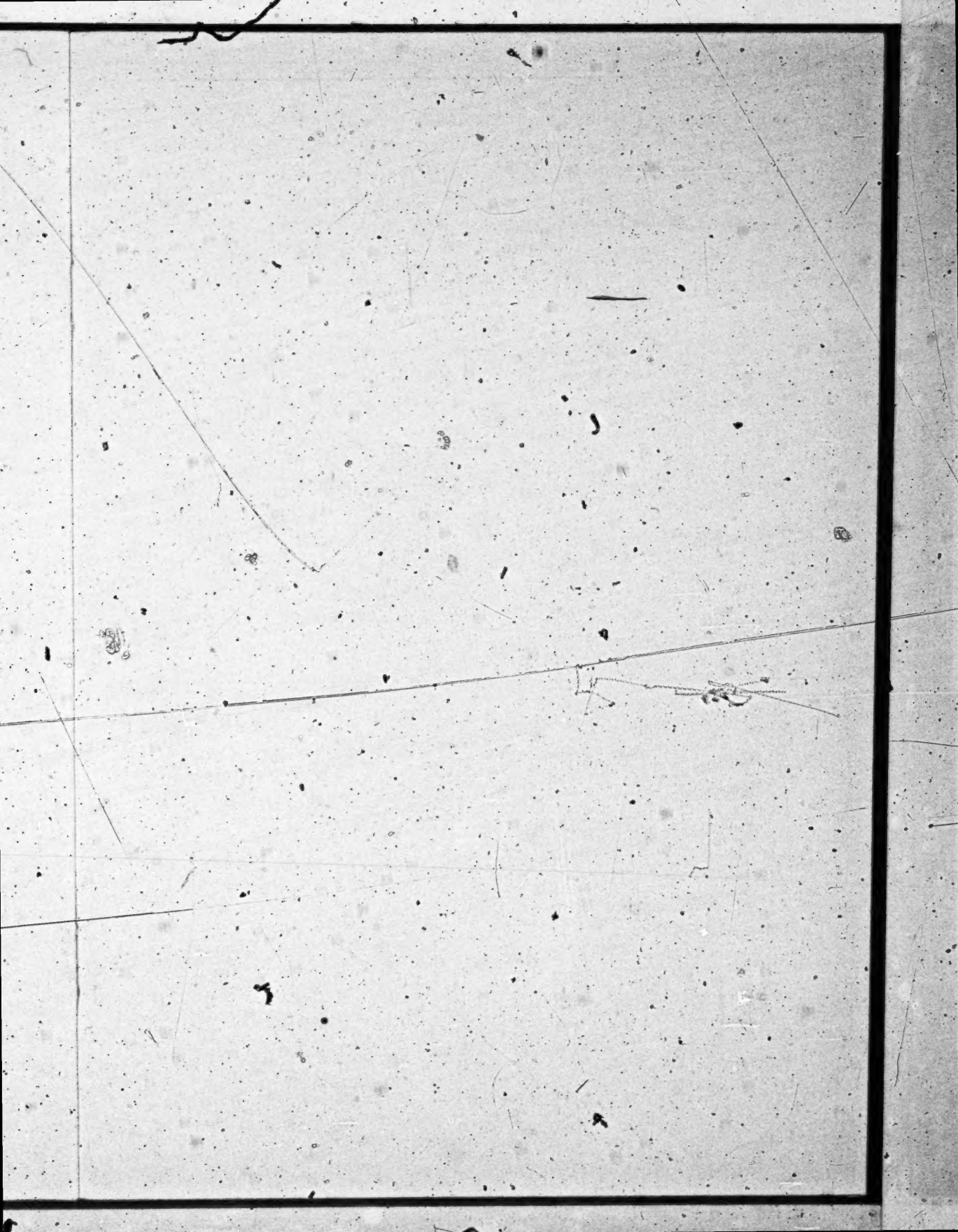

CAPLIN, TRUSTEE *v.* MARINE MIDLAND GRACE TRUST CO. OF NEW YORK

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 70-220. Argued March 28, 1972—Decided May 22, 1972

Petitioner, the trustee of Webb & Knapp, Inc., under Chapter X of the Bankruptcy Act, does not have standing to assert, on behalf of holders of debentures issued by Webb & Knapp, claims of misconduct by an indenture trustee. Pp. 417–435.

439 F. 2d 118, affirmed.

MARSHALL, J., delivered the opinion of the Court, in which BURGER, C. J., and STEWART, POWELL, and REHNQUIST, JJ., joined. DOUGLAS, J., filed a dissenting opinion, in which BRENNAN, WHITE, and BLACKMUN, JJ., joined, *post*, p. 435.

Charles H. Miller argued the cause for petitioner. With him on the briefs were *Mortimer M. Caplin, pro se*, *Henry Winestine*, and *Leon E. Irish*.

John W. Dickey argued the cause and filed a brief for respondent.

David Ferber argued the cause for the Securities and Exchange Commission urging reversal. With him on the briefs were *Solicitor General Griswold*, *Samuel Huntington*, *G. Bradford Cook*, and *Paul Gonson*.

MR. JUSTICE MARSHALL delivered the opinion of the Court.

The sole issue in this case is whether petitioner, the trustee in reorganization of Webb & Knapp, Inc., has standing under Chapter X of the Bankruptcy Act, 52 Stat. 883, 11 U. S. C. § 501 *et seq.*, to assert, on behalf of persons holding debentures issued by Webb & Knapp, claims of misconduct by an indenture trustee. The United States District Court for the Southern District

of New York held that petitioner lacked the requisite standing, and the United States Court of Appeals for the Second Circuit affirmed *en banc*, with two judges dissenting, 439 F. 2d 118 (1971).[1] We granted certiorari, 404 U. S. 982 (1971), and we now affirm the decision of the Court of Appeals.

I

Webb & Knapp and its numerous subsidiaries were engaged in various real estate activities in both the United States and Canada. In 1954, the corporation executed an indenture with respondent, the Marine Midland Trust Company of New York (Marine), that provided for the issuance by Webb & Knapp of 5% debentures in the total amount of $8,607,600. A critical part of the indenture was the promise by Webb & Knapp that neither it nor any company affiliated with it[2] would incur or assume "any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property . . . or purchase any real property or interests in real property" unless the company's consolidated tangible assets, as defined in the indenture, equaled 200% of certain liabilities, after giving effect to the contemplated indebtedness or purchase.[3]

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[1] The District Court delivered three separate opinions in this case. They are unreported, but are included in the appendix prepared by the parties at 58a–70a. The Court of Appeals heard the case *en banc* after a panel of three judges determined that it was inclined to overrule the case on which the District Court had placed almost exclusive reliance. 439 F. 2d 118.

[2] Those companies in the affiliated group include any corporation that was entitled to be included in a consolidated tax return of Webb & Knapp. See 26 U. S. C. § 1502. Section 1.1 of the Indenture gave Webb & Knapp authority to consider other companies as affiliates if it chose to do so.

[3] Indenture of June 1, 1954, Webb & Knapp, Inc., to the Marine Midland Trust Company of New York § 3.6 (hereinafter referred to as Indenture).